BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
WILLIAM. H. AND ELEANOR BLACK)

Appearances:
For Appellants: James Vizzard, Attorney at Law

For Respondent: F. Edward Caine, Senior Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of William H. and Eleanor Black to proposed assessments of additional personal income tax in the amounts of $1,832.24, $2,339.52, $1,482.37, $1,924.38 and $1,663.18 for the years 1952, 1953, 1954, 1955 and 1956, respectively,

Appellant William H. Black (hereinafter called appellant) was engaged in the coin machine business in the Eakersfield area under the name of Ace Amusement Company, He owned multiple-odd bingo pinball machines, claw machines, music machines, and miscellaneous amusement machines. The equipment was placed in bars, restaurants, and other locations, and the proceeds from each machine, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided equally between appellant and the location owner.

The maximum number of locations at any one time was about 25, and there was one music machine in each location. Most of the locations also had a pinball machine. There were only about six or seven claw machines and these were operated for only a portion of the years on appeal.

The gross income reported in tax returns was the total of amounts retained from locations. Deductions were taken for depreciation, cost of phonograph records , and other business expenses, Respondent determined that appellant was renting space in the locations where his machines were placed and that all the coins deposited. in the machines constituted gross income to him, Respondent also disallowed all expenses pursuant to section 17297 (17359 prior to June 6, 1955) of the Revenue and Taxation Code which reads:

> In computing taxable income, no deductions shall be allowed to any taxpayer on any of his gross income derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deductions be allowed to any taxpayer on any of his gross income derived from any other activities which tend to promote or to further, or are connected or associated with, such illegal activities*

The evidence indicates that the operating arrangements between appellant and each location owner were the same as those considered by us in Appeal of Hall, Cal, St, Bd. of Equal,, Dec. 29, 1958, 2 CCH Cal, Tax Cas. Par. 201-197, 3 P-H State & Local Tax Serv. Cal. Par, 58145, Our conclusion in Hall that the machine owner and each location owner were engaged in a joint venture in the operation of these machines is, accordingly, applicable here.

In Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal,, Oct. 9, 1962, 3 CCH Cal. Tax Cas. Par.- ___, 2 P-H State & Local Tax Serv. Cal. Par. 13288, we held the ownership or possession of a pinball machine to be illegal under Penal Code sections 330b, 330.1, and 330.5 if the machine was predominantly a game or chance or if cash was paid to players for unplayed free games, and we also held bingo pinball machines to be predominantly games of chance.

From the evidence presented it appears that it was the general practice to pay cash to players of appellant's pinball machines for unplayed free games, Accordingly, the pinball machine phase of appellant's business was illegal both on the ground of ownership and possession of bingo pinball machines, which were predominantly games of chance, and on the ground that cash was paid to winning players. We have previously held the operation of a claw machine to be illegal whether or not a successful player is permitted to redeem the merchandise for cash. (Appeal of Perinati, Cal, St, Bd. of Equal,, April 6, 1961, 3 CCH Cal, Tax Cas. Par. 201-733, 3 P-H State & Local Tax Serv. Cal, Par, 58191; Appeal of Seeman, Cal, St, Bd. of Equal,, July 19, 1961, 3 CCH Cal. Tax Cas. Par. 201-825, 3 P-H State & Local Tax Serv. Cal, Par. 58208,) Inasmuch as there was illegal activity, respondent was correct in applying section 17297.

Most of the locations had a pinball machine and a music machine together, Appellant personally operated the entire business, that is, he made all collections and repairs, purchased equipment, placed equipment in the locations, and kept the records. There was, therefore, a substantial connection

between the illegal operation of claw machines and bingo pinball machines and the legal operation of the other equipment and respondent was correct in disallowing all expenses of the business*

There were no records of amounts paid to winning players on the bingo pinball machines and the claw machines and respondent estimated these unrecorded amounts as equal to 45 percent of the total amount deposited in such machines.

Respondent's auditor testified that at the time of the audit in 1958, appellant told him that the payouts on pinball machines ran between 30 and 60 percent of the total deposited in the pinball machines and that the payout percentage on the claw machines ran a little higher than on the pinball machines. Respondent's auditor testified that he used the 45 percent figure as the midpoint between the extremes given by appellant and further testified that this figure was not inconsistent with his experience in auditing other operators. We conclude that the 45 percent estimate is reasonable. It appears that if the estimate is in error, it is probably too low rather than too high,

In connection with the determination of the unrecorded payouts it was necessary for respondent's auditor to estimate the percentage of appellant's gross income which was derived from pinball and claw machines inasmuch as his records did not break down the income by type of machine. For this purpose respondent's auditor used an estimate that 2/3 of the recorded gross income was from pinball and claw machines, and 1/3 from music and miscellaneous machines. This estimate was given by appellant at the time of the audit in 1958. The testimony of appellant in the record established before us indicates that the 2/3 estimate was at the high end of a range between 1/2 and 2/3 but does not clearly demonstrate that the estimate was too high,, Under the circumstances we believe that the 2/3 estimate must be upheld,

Appellant has raised a question as to whether the notices of proposed assessment were timely. The notices of proposed assessment were issued by respondent on March 17, 1959. The returns for the years 1952, 1953, 1954, 1955, and 1956 were due on April 15, 1953, 1954, 1955, 1956, and 1957, respectively, (Rev. and Tax, Code, Par, 18432.) The notices of proposed assessment for 1954, 1955, and 1956 were issued less than four years after the due date of the returns. The notices of proposed assessment for 1952 and 1953 were issued more than four years and less than six years after the due date of the returns.

Section 18586 provides a general four-year period for respondent to issue a notice of proposed assessment, Section

18586.1 extends the period to six years if the taxpayer omits from gross income an amount in excess of 25 percent of the gross income stated in the return. Under either section, the time starts to run upon the filing of a return, except that if the return is filed. prior to the final date for filing, the time starts to run on such final date, (Rev, and Tax, Code, Par, 18588,)

The notices of proposed.assessment were timely for the years 1954, 1955, and 1956 under the general four-year limitation, The amount of gross income not reported for 1952 and 1953 was appellant's share of the payments to winning players *on* pinball and claw machines. The amount of gross income reported by appellant for these years was his share of the proceeds of the machines. For the years 1952 and 1953 appellant's unreported gross income computed in accordance with the earlier part of this opinion, is approximately 50 percent of his reported gross income for each of those years. Accordingly, the gross income omitted was in excess of 25 percent of the gross income reported for each of the years 1952 and 1953 and the notices of proposed assessments for these years were timely.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of William H. and Eleanor Black to proposed. assessments of additional personal income tax in the amounts of $1,832.24, $2,339.52, $1,482.37, $1,924.38 and $1,663.18, for the years 1952, 1953, 1954, 1955 and 1956, respectively, be modified in that the gross income is to be recomputed in accordance with the opinion of the board, In all other respects the action of the Franchise Tax Board is sustained.

Done at Pasadena, California, this 27th day of November, 1962, by the State Board of Equalization,

George Ii, Reilly, Chairman
Richard Nevins, Member
Paul R. Leake, Member
John W. Lynch, Member
_____, Member

ATTEST: Dixwell L. Pierce, Secretary